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Slaughter and May Podcast
Climate-related issues for Occupational Pension Schemes

Richard Goldstein	Hello my name is Richard Goldstein, I'm a Consultant and Head of Pensions Knowledge here at pensions group at Slaughter and May. In this podcast, I'm going to cover the Government's proposals that it recently published on improving governance and reporting of climate-related issues for Occupational Pension Schemes. By way of summary in August 2020 the departments for Work and Pensions published proposals for legislation and statutory guidance on governance and reporting of climate change issues. In line with recommendations of the Task Force on Climate Related Financial Disclosures of TCFD. Trustees of large occupational pension schemes, authorised master trusts, and collective DC schemes will be required; one to address climate change risks and opportunities through effective governance and risk management measures and; two publish an annual report on such measures to be known as a TCFD report. Under the proposed new rules Trustees will be responsible for a variety of strategic and risk management activities. Including scenario analysis such as how the schemes assets would be affected by a global average temperature rise of 2 degrees Celsius above pre-industrial levels. Identifying suitable metrics and using them to measure and manage the climate related risks and opportunities associated with the scheme and setting targets and reporting on performance against them. Whilst some of the legislation and guidance will be quite prescriptive the government recognises that there are unlikely to be sufficient data to allow a full quantative analysis to be carried out. Trustees will therefore be able to depart from the statutory guidance, provided they explain why and in some cases Trustee's will be permitted to meet the requirements as far as they are able to do so. Although Trustees of smaller schemes will not, in the first three years, be required to comply with the TCFD recommendations, they will need to address climate risk as part of their schemes investment governance. The new pensions schemes bill includes powers to make regulations; 1. Imposing requirements on Trustees with a view to ensuring there is effective governance of the scheme with a respect to the effects of climate change; and 2. Requiring information relating to the effects of climate change on the scheme to be published. The government proposes to translate the TCFD recommendations into legislative requirements in the form of regulations supported by statutory guidance. Although this substance of the TCFD recommendations will stay for some time, some adjustments will be needed to make them work in a pension schemes context.

By way of further context, climate related risks can generally be grouped into two types; physical risks, such as extreme weather events, changes in sea levels and advert gradual changes in climate and transition risks. These are risks associated with action to tackle climate change, such as changes in government policy, technology and consumer preferences. Consequences of these risks include business disruption, destruction or impairment of assets, migration of workers and increases in energy prices.

Pension schemes are potentially exposed to climate related risks whether investing in active or passive strategies. Pools or segregated mandates and over different time horizons. The financial position of the sponsor may also be affected.

In March this year the Pensions Climate Risk Industry Group or PCRIG, an industry group set up to help trustees meet their legal requirements, published for consultation draft non-statutory guidance on how trustees can integrate climate issues into their existing government processes. The guidance is aimed at schemes of all types. Given the nature and likely materiality of the risks posed by climate change the PCRIG considers that Trustees fiduciary duties require them to take into account the financial impact of these risks alongside other risks when setting investment strategy, and the Trustees duties are not limited to traditional risks such as interest rate, currency exchange rates or inflation risks. In the past, Trustees might not have used climate change risks as a quantifiable financial risk.

Other regulatory developments are also relevant. By 1st October 2019, schemes had to update their statement of investment principals or SIP to include policies in relation to financially material risks and opportunities. From October this year, trustees will be required to explain how their arrangements with the schemes assets manager - incentives the alignment of the investment manager with a SIP and include an implementation statement setting out how the SIP has been followed during the year. Although the requirements for DB schemes are somewhat more limited.

The forthcoming code of practice on governance will require trustees to carry out an assessment of whether and how they assess risks, the use of resources and the environment. As foreshadowed in the pension schemes bill, the DWP has now decided to go further and require trustees of larger occupational pension schemes, authorised master trusts and collective DC schemes essentially to comply with the TCFD requirements. The government will consider whether the schemes meeting the TCFD requirement in line with new regulations will be deemed also to meet the standards in the code of practice on governance so far as they relate to climate change. However, the government does not intend the new requirements to dictate Trustees' investment decisions. Trustees of smaller schemes will not in the first few years be required to comply with the TCFD recommendations. But they will need to address private risks as part of the schemes investment governance. Trustees of schemes of all sizes may find it helpful to refer to the non-statutory guidance published by the PSRIG. The final version of which is expected to appear soon.

Looking at the difference between DB and DC schemes, Trustees of DB schemes will need to consider the financial impact of climate related risks and opportunities on the stead assets and liabilities and the covenant of the sponsoring employer. The latter will involve consideration of the schemes funding levels and employer covenant as part of the integrated risk management or IRM approach that has to be adopted. Trustees of DC schemes will need to consider the financial impact of climate related risk and opportunities on the risk return profile appropriate to membership, and the investment risk and returns of the default fund and any applicable member's self-selected funds.

The PCRIG are clearly of the view the trustees must not relegate the consideration of climate change via members to self-select funds.

In terms of scope and timing, the regulations will initially apply to larger occupational pension schemes, authorised master trusts and collective DC schemes. Occupational pension schemes with 5 billion or more in net assets on the first scheme year to end on or after the 1st June 2020. As well as authorised master trusts and all collective DC schemes as at 1st October 2021 will be required to:

1. Have a system of climate governance for the relevant scheme year in place on 1st October 2021; and

2. Publish an annual TCFD report, the first report within seven months at the end of that scheme year underway on 1st October 2021, or by 31st December 2022, if earlier.

The following year these requirements will be extended to schemes with assets of 1 billion or more. Where schemes net assets exceed 1 billion on the first scheme year to end on or after 1st June 2021, the government's requirements will apply to the scheme year underway from 1st October 2022 and the TCFD report would be due 7 months after the end of that scheme year or 31st December 2023, if earlier. Schemes would remain in scope until their net assets fall below 500million at the scheme year end. The DWP will consider in 2024 whether to extend the requirements to smaller schemes.

Looking at a bit more of the detail, I am going to cover governance, strategy, scenario analysis, risk management, metrics and targets.

Starting with Governance, Trustees have to establish and maintain processes to ensure that persons managing schemes are assessing and managing climate related risks and opportunities, and the Trustees themselves have oversight of climate related risk and opportunities. The company's statutory guidance will include quite detailed prescriptive requirements including roles and responsibilities, integration of a consideration of climate change into the scheme's existing governance, and the types of prices that Trustees should put in place to ensure external advisers or employees are informed about and monitor time related issues effectively. Whilst some larger pension schemes may invest to a segregated portfolio manager, in many cases Trustees will invest through pulled funds. The PCRIG draft guidance suggests Trustees

	should identify funds and managers which adopt an investment approach aligned with the Trustee's investment belief. The draft guidance contains a sample list of enquiries to raise with an Asset Manager, it highlights the important role of the investment consultant. One proposal is that the objectives for the investment consultant could include addressing climate related risks and opportunities mature to the scheme and adopting the core services accordingly. Next in terms of strategy, Trustees have got to identify on an ongoing basis climate related risks and opportunities that would have an effect on the investment in the case of DV Schemes funding strategy for the scheme over short, medium and the longer terms. The guidance will support Trustees to understand and identify risks and opportunities by providing examples that Trustees should consider and report on, such as the increased pricing of greenhouse gas emissions or carbon, substitution of existing products and services with lower emission alternative, successful investment in new technology and litigation risks. Guidance will also help Trustees assess risks and opportunities to individual scheme sections in different asset classes. In the DB Scheme, this will involve considering the scheme's funding level and employ covenants as part of an IRM approach, in the DC Schemes the Trustees should consider the risk return profile appropriate to membership and in particular the design of the default investment strategy. In terms of scenario analysis at least annually as far as they are able to, Trustees have to assess the resilience of the scheme's assets and liabilities and investment strategy and in the case of DB Schemes funding strategies to climate related risks in at least two climate related scenarios. Including at least one scenario the representative eventual global average temperature rise of between one and a half and two degrees Celsius from pre-industrial levels. The DWP recognises that such analysis is particularly challenging given the lack of data available. The government does not propose to prescribe where the scenario analysis should be qualitative or quantitative. Guidance will set out what level of endeavour is expected of Trustees and how to use the outputs of scenario analysis to inform their understanding. For DB Schemes scenario analysis should be used to assess the impact of different scenarios on spencer covenant and funding levels as well as investment portfolios. The DC Schemes scenario analysis should focus on the effect of different warming and transition scenarios on member's pension pots. Next by way of risk management, Trustees have to adopt and maintain on an on-going basis processes to identifying, assessing and managing climate related risks, and ensure that climate related risks are integrated into overall risk management apparatus. Statutory guides will set out factors that Trustees should take into account when deciding how to prioritise the various risks they identified based on materiality, including likelihood and financial impact and working with Asset Managers and others to ensure their identified risks are managed and addressed in the investment chain.

	The PCRIG draft guidance notes that the scales and complexity of climate change and its resulting impacts require strong and well defined risk management processes to ensure the risks are managed effectively. PCRIG suggests that Trustees may consider a number of strategic actions to reduce identified exposure to risk, which might include a shift in passive investments to low carbon benchmarks, rather than tracking and market capitalisation weighted and indexed. Next in terms of metrics, Trustees have to select at least one appropriate greenhouse gas emissions based metrics or GHG metrics, and at least one other non-emission based metric to assess scheme assets against climate related risk and opportunities and review the selection on an on-going basis. Data must be obtained on a quarterly basis to inform the targets that are set. The guidance will state the Trustees should choose their weighted average carbon intensity or WACI as their emissions based metric. The proposal is to impose identical requirements on scope 1 emissions - these are all direct emissions from the activities of an organisation. Scope 2 emissions - these are indirect emissions from electricity purchased and used and scope 3 emissions - these are all other indirect emissions from sources the organisation does not control such as business travel, procurement, waste and water. The PCIG's draft guidance contains more detailed explanations of the different metrics available and their advantages and potential drawbacks. And finally in terms of targets, at least annually Trustees must set at least one target to manage calculated risks for one of their matrix, which can be emissions based metrics or non-emissions based metrics. Trustees will be required to measure performance against the target at least quarterly, guidance will set out the matters to which the Trustees must have regard including whether the target is absolute or in tentative base timeframes over which the target applies. The base year from which progress is measured and key performance indicators. Several benchmarks are already publicly available for many of these metrics. The MSCI produced a free directory of WACI's for 20 indices. And finally I am going to cover TCFD's report itself. The annual TCFD report will have to include information about how the Trustees have implemented measures to identify monetary managed climate related risk issues. Where Trustees depart from statutory guidance they will need to explain the reasons for doing so. Trustees will have to: 1. Publish the TCFD report so it as assessable free of charge on a publicly available website; 2. Reference to TCFD report in the schemes annual report and accounts. They will have to tell members by their annual benefit statements that the most recent TCFD report has been or will be published and where they can locate it. The DWP proposes that the DB schemes, this would apply only for members whom they are already required to produce an annual benefit statement. The DC schemes are web linked to direct members to single page containing

the TCFD report, the chair statement exerts, SIP and implementation statement.

3. The third requirement is they have to provide the pension's regulator with a web address where they have published their TCFD report by the annual scheme return. The regulations on registered report information would be amended to make this a mandatory requirement of the scheme return. The TCFD report will not have to be audited.

By way of penalty to non-compliance the DWP proposes a mandatory penalty with a minimum of £2,500 only for wholesale non-compliance i.e. failure to publish a TCFD report at all. Penalties for a report that the TPR deems to be inadequate it meets the requirement regulations would be subject to discretion and the maximum £5,000 for individual Trustees and £50,000 for Corporate Trustees. Additionally, requirements to reference the TCFD reports in the annual report and to inform members would be subject to the existing penalty regime in this disposal regulation.

That ends this podcast, if you have any feedback or comments, please feel free to email me at Richard.Goldstein@SlaughterandMay.com.